

“BAILEY” RETIREMENT

Personal Income Tax Deduction for amounts
received from Government Retirement Plans

G.S. 105-153.5(b)(5)

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G.S. 105-153.5

The amount received during the taxable year from one or more State, local, or federal government retirement plans to the extent the amount is exempt from tax under this Part pursuant to a court order in settlement of any of the following cases:

- Bailey v. State
- Emory v. State
- Patton v. State

- S.L. 2013-316 broadened the PIT base and lowered the PIT rates.
- One deduction that could not be eliminated was the “*Bailey*” retirement deduction.



North Carolina Retirement Systems

History of Government Retirement Deduction

- 1939
 - NCGA provided retirement benefits to State and local government employees
 - Those benefits exempt from State income tax
 - Practice of many states
- 1989
 - *Davis v. Michigan*
 - Violated principle of intergovernmental immunity
- Legislative response
 - Tax all retirement benefits
 - \$4,000 deduction for government retirement benefits
 - \$2,000 deduction for private retirement benefits
- 1990
 - *Bailey v. North Carolina*
 - Unconstitutional impairment of contract
- 1998
 - NC Supreme Court affirmed trial court decision

“Bailey” Retirees

- Class Action Settlement
 - October 7, 1998
 - State appropriated \$799,000,000 for refunds to State, local, and federal retirees for tax years 1989 through 1997
 - For income tax paid on retirement benefits
 - For taxpayers who were “vested” for receipt of those benefits
 - Vested retirees will not pay NC income tax in future years on their government retirement benefits
- Vesting period
 - Retirement system: Typically 5 or more years of creditable service on or before August 12, 1989
 - NC’s Supplemental Retirement Income Plan – 401(k)s and NC’s Deferred Compensation Plan – 457s: Contributed any money to the plan by August 12, 1989

Supplemental Retirement Plans



- 1998
 - Court order designated NC Supplemental Retirement Plan as a qualifying retirement plan
- 2002
 - Federal law changes with respect to pension portability
 - Distributions from most types of retirement plans may be rolled over into another retirement plan or into an IRA

“Bailey”, 401(k)s, and “Roll Over Funds”

- ***Directive PD-03-1***

- Address consequences of rolling over amounts from other retirement plans or IRAs into a qualifying tax-exempt *Bailey* retirement account
- June 30, 2003
- If account includes rollover distributions, only a portion of the retirement benefits is exempt from NC income tax

- ***Directive PD-04-1***

- Questions arose about DOR’s decision to tax a portion of a distribution from a qualifying tax-exempt *Bailey* account that included rollover distributions from a non-qualifying *Bailey* account
- AG opinion sought
- AG opinion that all distributions from State 401(k) plan to an eligible individual is exempt from income tax regardless of the source of the funds

PD 03-1

- Address consequences of rollover distributions
 - Order Regarding the Optional Retirement Program for Institutions of Higher Education, November 19, 1999
 - Participant moves from one institution of higher education in the U.S. to another
- Benefits exempt only if, and to the extent, the ORP contributions and earnings retain their character as ORP contributions and earnings
 - Transfer the ORP account into another benefit plan, lose their character and not exempt
 - Not transferred and receive separate check, fully exempt
 - Not transferred, but combines accounts for payment, prorated exemption
 - Not transferred, and contributions of new employer added to existing ORP account, prorated exemption

Advisory Opinion from Attorney General

- All benefits from state-created and state-administered plans should be treated as tax-exempt, without regard to source of funds
 - Acknowledged that state and federal laws have enhanced the benefits available through *Bailey* accounts
 - Principle of *Bailey* decision is that State entered into contract with members
 - All benefits paid by plans to members who were vested by the relevant date are exempt, without regard to whether those benefits are attributable to service prior to or after that date
 - Nothing in *Bailey* suggests that exemption limited to specific benefits contained in statutes or plan documents as of August 12, 1989
 - Rollover distributions lose their character upon rollover
 - All distributions from *Bailey* account exempt, regardless of source of funds

Policy Considerations and Options

Considerations

- Legislative intent
- Purpose of pension portability
- Percentage of accounts attributable to rollover funds
- Cost of exempting distributions attributable to rollover funds
- Scope of issue

Options

- Do nothing
- Prohibit future rollovers into tax-exempt *Bailey* account from a *non-Bailey* account
- Statutorily clarify that the *Bailey* tax exemption does not apply to funds rolled into a *Bailey* account from a non-qualifying retirement plan